Internal Revenue Service

memorandum

CC:TL:Br4
CBBehling

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to: Deputy Regional Counsel (TL) CC:C
Central Region

from: Director, Tax Litigation Division CC:TL

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subject: Litigation Cost Awards Under I.R.C. Section 7430

This memorandum responds to your request for technical advice concerning the Government's potential liability for an award of attorney's fees under I.R.C. section 7430 if the Government continues to defend the Cleveland Athletic Club, Inc. v. United States, 779 F.2d 1160 (6th Cir. 1985), issue in the Sixth Circuit.

BACKGROUND OF I.R.C. SECTION 7430

As amended by Congress in 1986, Internal Revenue Code section 7430 generally provides for an award of attorney's fees in the case of any civil proceeding brought by or against the United States in connection with the determination, collection, or refund of any tax, interest, or penalty when the prevailing party demonstrates that the position of the United States in the proceeding was not substantially justified. Under I.R.C. section 7430(c)(2)(A)(iii), an individual will not qualify as a party to the litigation if his or her net worth exceeds $2,000,000 at the time the adversary adjudication was initiated. However, an organization described in I.R.C. section 501(c)(3) and exempt from taxation under I.R.C. section 501(a) or a cooperative association as defined in section 15(a) of the Agricultural Marketing Act may be a party regardless of its net worth. 5 U.S.C. section 504(b)(1)(B).

Congress amended section 7430 to conform that provision more closely to the Equal Access to Justice Act. S. Rept. No. 313, 99th Cong., 2d Sess. 198 (1986), 1983-3 C.B. (Vol. 3) 198. The amended provision applies to payments made after September 30, 1986, in tax proceedings commenced after December 31, 1985. Prior law required the taxpayer to prove the Government's position in the civil proceeding "was unreasonable." The amended statute requires the taxpayer to establish that the Government's position in the civil proceeding was "not substantially justified." I.R.C. section 7430(c)(2)(A)(i). The

Tax Court, however, has stated that it will continue to look to the legislative history of section 7430 before amendment for guidelines in evaluating the Government's position. The Tax Court noted:

> There is no suggestion in the legislative history that the "substantially justified" standard was intended to be a departure from the "reasonableness" standard. In fact, the legislative history to the Equal Access to Justice Act indicates that the substantially justified test under that statute is essentially one of reasonableness.

Sher v. Commissioner, 89 T.C. 79, 84 (1987).

A review of the legislative history of section 7430 before its amendment in 1986 and of the cases applying that legislative history indicates that the court's determination of reasonableness is to be made based upon all the facts and legal precedents relating to the case as revealed in the record. See, e.g., DeVenney v. Commissioner, 85 T.C. 927 (1985). Moreover, Congress set forth specific factors that the courts should take into account in determining reasonableness:

> (1) whether the Government used the costs and expenses of litigation against its position to extract concessions from the taxpayer that were not justified under the circumstances of the case,
>
> (2) whether the Government pursued the litigation against the taxpayer for purposes of harassment or embarrassment, or out of political motivation, and
>
> (3) such other factors as the Court finds relevant.

See, e.g., Sher v. Commissioner, 89 T.C. 79 (1987), quoting with approval, H. Rept. 404, 97th Cong., 1st Sess. 12 (1981).

DISCUSSION

Because the courts require that the Government's position must be reasonably based upon both fact and law, presumably the courts would not find "substantial justification" where a case precedent is clearly against the Government's litigating position. Therefore, the Government's position would be "unreasonable." For example, in a reviewed decision, the Tax

Court concluded that the Government's position was unreasonable because the IRS had sought to repudiate a well-established line of cases, including opinions of the Tax Court and the Fifth and Ninth Circuit Courts of Appeals. The Tax Court, in noting that it saw no reason to depart from such established precedent and that it would follow the Fifth Circuit's well-reasoned and thoroughly researched opinion, found that the Government's "persistence" was unreasonable. Minahan v. Commissioner, 88 T.C. 492, 500 (1987).

We note that the Tax Court in Minahan stated it would leave to another day the question of when the Government's efforts to create a conflict among the circuits would suffice to save the IRS from being unreasonable. Id. at 501. However, our review of the cases indicates that the Government could argue that its decision to challenge the Cleveland Athletic Club issue in circuits other than the Sixth Circuit is substantially justified as part of the IRS enforcement scheme. As the Second Circuit has noted:

> In federal tax cases disputed questions of law are satisfactorily resolved only by U.S. Supreme Court decisions, for the Commissioner of the Internal Revenue Service has on many occasions taken the position . . . that a Court of Appeals decision with which he disagrees has no binding effect on the Service's policies in other circuits.

Divine v. Commissioner, 500 F.2d 1041, 1049 (2d Cir 1974).

The Supreme Court generally will grant certiorari in tax cases when two or more circuits have adopted conflicting positions. See S. Ct. R. 17.1.(a). Thus, the Government can contend that it is justified in seeking to establish precedent in other circuits to conflict with the Cleveland Athletic Club decision in the Sixth Circuit. The Government can support this argument with the Supreme Court's decision in United States v. Mendoza, 464 U.S. 154 (1984). The Supreme Court held that nonmutual offensive collateral estoppel did not apply to preclude the Government from relitigating the constitutionality of certain immigration administrative procedures. In part, the

Court relied on the following reasoning:

> A rule allowing nonmutual collateral estoppel against the Government . . . would substantially thwart the development of important questions of law by freezing the first final decision rendered on a particular legal issue. Allowing only one final adjudication would deprive this Court of the benefit it receives from permitting several courts of appeals to explore a difficult question before this Court grants certiorari. . . . Indeed, if nonmutual collateral estoppel were routinely applied against the Government, this Court would have to revise its practice of waiting for a conflict to develop before granting the Government's petition for certiorari.

Id. at 160.

Mendoza, however, does not settle the question concerning the Government's potential liability under section 7430 if the Government continues to defend the Cleveland Athletic Club issue in the Sixth Circuit. Allowing the Government to relitigate an issue in order to establish a conflict among the United States Circuit Courts of Appeals is considerably different than not penalizing the Government with attorneys' fees liability for an unsuccessful subsequent effort to raise the same issue in the same circuit with precedent unfavorable to the Government. As the Court of Appeals for the D.C. Circuit noted:

> The government is always free, of course, to seek modification or repudiation of established doctrine, but individual private litigants should not be compelled to subsidize such reevaluations of controlling doctrine.

Spencer v. NLRB, 712 F.2d 539, 559 (D.C. Cir. 1983).

The D.C. Circuit Court of Appeals further stated that

> the importance of a legal issue may justify a decision by government counsel to "take a long shot" -- for example, to argue on appeal for the overruling of a controlling precedent unfavorable to the United States, even though the likelihood of obtaining such a judgment is slight. . . [W]hen the government loses such a case, it should be obliged to reimburse the private party for his attorney's fees.

Id. at 558. The court concluded that "if the issue is important enough, government officials, who of course are not personally liable for the payment of fees, should not be dissuaded by the prospect of an award of fees to a private party's counsel." Id. at 559.

Citing the Spencer v. NLRB case with approval, the Court of Appeals for the Eighth Circuit noted that "if the government chooses to embark on such an escapade . . . , it should be prepared to pay the piper." Keasler v. United States, 766 F.2d 1227, 1238 (8th Cir. 1985).

By a CATS message dated September 17, 1986, CC:TL:Br4 noted that the Second Circuit Court of Appeal's subsequent decision in [redacted] disagrees strongly with the Sixth Circuit Court of Appeals decision in Cleveland Athletic Club. As a result, the National Office advised all offices:

> Now the guidance in the Cleveland Athletic Club AOD [CC-1986-026 distributed May 14, 1986] regarding an inter-circuit conflict is effective and we will no longer concede cases in the venue of the 6th Cir. Also, the allocation of expenses should be examined to insure that excessive allocation of expenses to non-member sales, producing a greater loss, is not being made.

In light of the fact that the Government is holding the line nationwide on the Cleveland Athletic Club issue and has made a decision not to concede the issue in the venue of the Sixth Circuit, we conclude that the IRS should continue to defend this issue in that venue. Tax Court cases and refund suits are pending in the venue of the Sixth Circuit. The Department of Justice is continuing to defend the refund suits. Moreover, the Department of Justice appellate attorney handling the Government's appeal in North Ridge Country Club v. Commissioner, 89 T.C. 563 (1987) (appeal filed 9th Cir. January 29, 1988), informally has advised us that, if the situation warrants, the Department of Justice would have little difficulty in asking the Sixth Circuit to reconsider Cleveland Athletic Club, especially if the Ninth Circuit reverses North Ridge Country Club and the taxpayer does not seek certiorari. Any award of litigation costs would also be appealed. The issue is widespread enough that, with the split in the circuits, Supreme Court review is likely in some manner.

We also point out that the "substantially justified" standard of amended section 7430 applies to the Government's position in both the civil proceeding and any administrative action or inaction by IRS District Counsel (and all subsequent administrative action or inaction) upon which such proceeding is based. I.R.C. section 7430(c)(4). By specifically defining the Government's position to include its prelitigation conduct, Congress addressed a critical difference among the circuits. The District of Columbia, Tenth, and Eleventh Circuits had interpreted "position of the United States" as allowing an examination of only the Government's in-court litigating position. Baker v. Commissioner, 787 F.2d 637, 641-642 (D.C. Cir. 1986); United States v. Balanced Financial Management, Inc., 769 F.2d 1440 (10th Cir. 1985); Ewing & Thomas, P.A. v. Heye, 803 F.2d 613 (11th Cir. 1986); Ashburn v. United States, 740 F.2d 843, 848 (11th Cir. 1984). The First and Fifth Circuits, on the other hand, had interpreted "position of the United States" as allowing an examination of both the prelitigating and litigation positions of the Government. Kaufman v. Egger, 758 F.2d 1, 4 (1st Cir. 1985); Powell v. Commissioner, 791 F.2d 385, 391 (5th Cir. 1986). New section 7430(c)(4), however, does not open all of the Government's prelitigation conduct to inquiry. As the Tax Court has stated, "application of the substantially justified standard to administrative actions or inactions prior to the institution of a proceeding is limited to the period beginning with the point at which District Counsel has become involved." Sher v. Commissioner, 89 T.C. 79, 86 (1987).

CONCLUSION

We recommend that in the Sixth Circuit you not concede cases involving the Cleveland Athletic Club issue based on a fear that a court will award litigation costs under I.R.C. section 7430. If you require our further views, please advise us. The

division is completing a comprehensive Litigation Guideline Memorandum that it will distribute soon dealing with litigation costs.

MARLENE GROSS
Director

By: _____
HENRY G. SALAMY
Chief, Branch No. 4
Tax Litigation Division

cc: Deputy Regional Counsel (TL) CC:SE
Southeast Region